Michigan League for Human Services

The House Tax Policy Committee

A Tax Structure for the 21st Century

Lansing, MI

June 10, 2009

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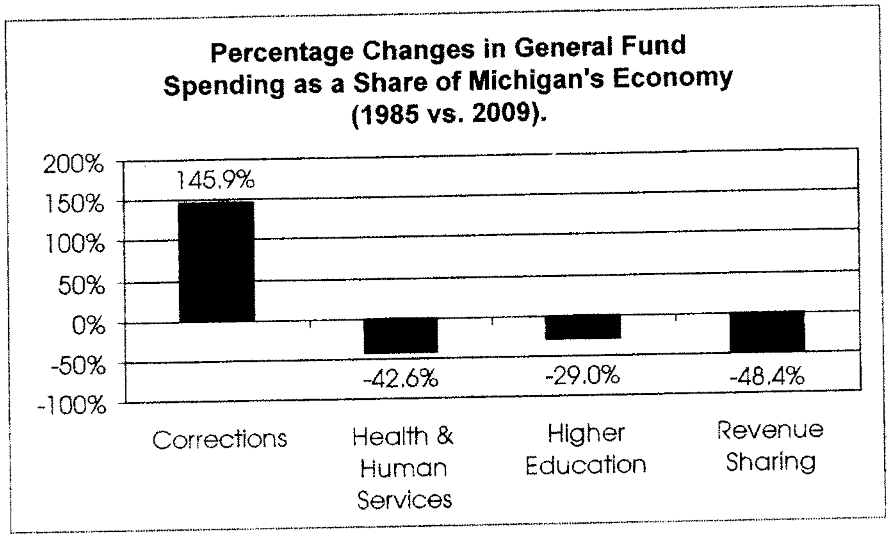
A United Way Agency

Michigan's Battered Economy Means Greater Need for Services

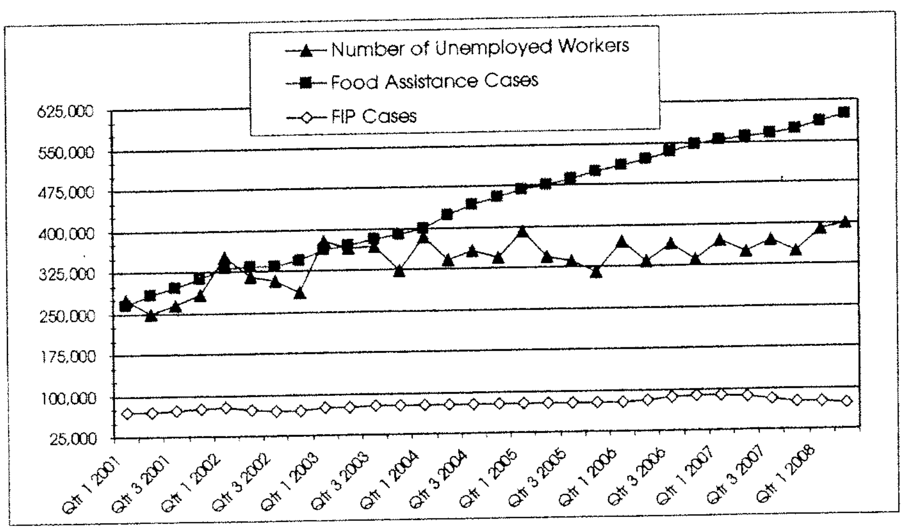
- 25 percent increase in family poverty, 2001-2007
- 19 percent of children live in poverty
- One in eight persons receiving food assistance (over 650,000 households)

Priority Shift



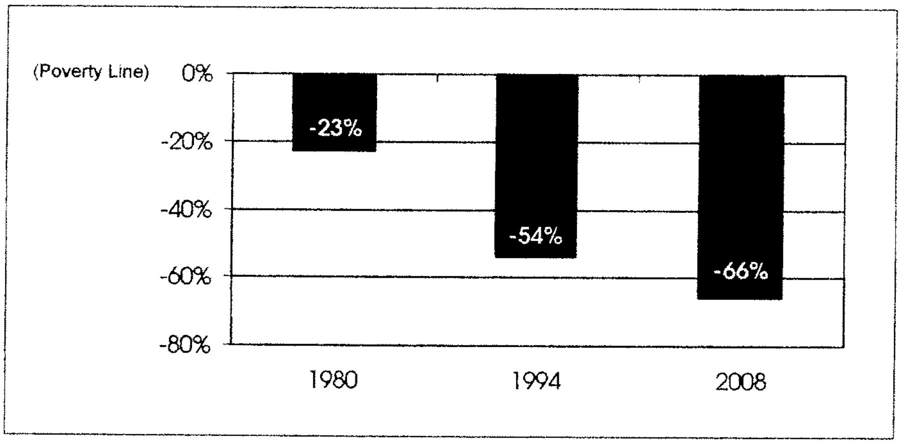
Calculations by Michigan League for Human Services

Number Unemployed, Food Assistance Cases and FIP Cases Since 2001



Source: U.S. Bureau of Labor Statistics and Michigan Department of Human Services

Maximum Cash Assistance Grant Trend Percent Below Poverty Line (three-person household)

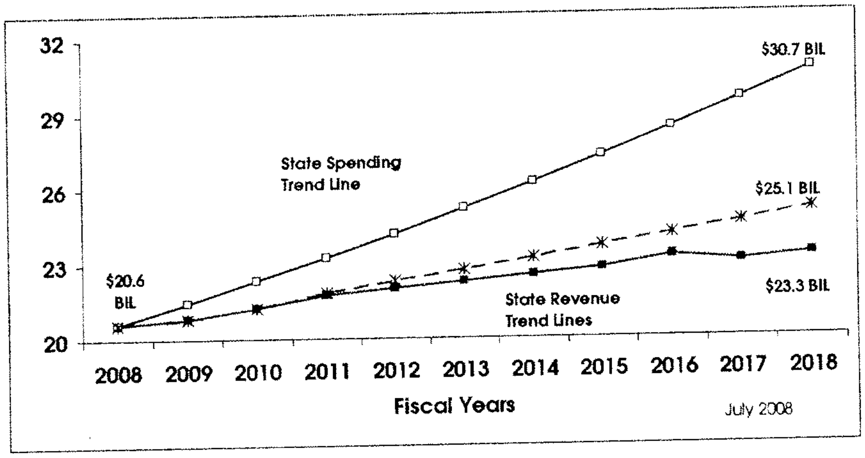


Prepared by the Michigan League for Human Services

Current Policies are Not Addressing Problems

- The tax fix enacted in 2007 is temporary
- New tax cuts pose additional threats to revenue
- Additional spending cuts will be harmful
- Michigan has a structural deficit that is growing

Michigan's Projected School Aid and General Fund Structural Deficit (FY2008 - FY2018)



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Sales Tax on Services: Modernizing the Revenue Structure

- Michigan only taxes 26 services out of a possible 168
- In 2008, taxable sales accounted for only 38.4 percent of personal income, compared with 50 percent in 1978
- Thirty-eight states and the District of Columbia tax more services than Michigan

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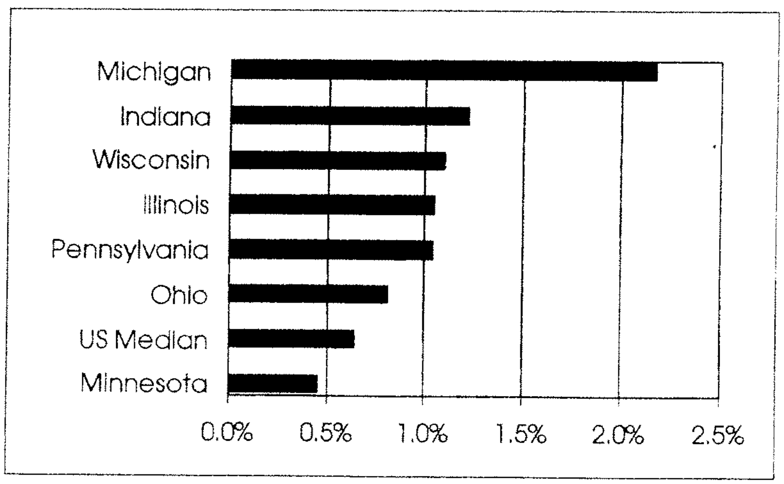
Income Tax: It's Time for the Flat Tax to Go

- Only seven states have a flat tax
- 34 states and the District of Columbia have a graduated tax
- A graduated tax could help at least 90 percent of filers

Senior Citizen Income Tax Preferences in the Great Lakes Region



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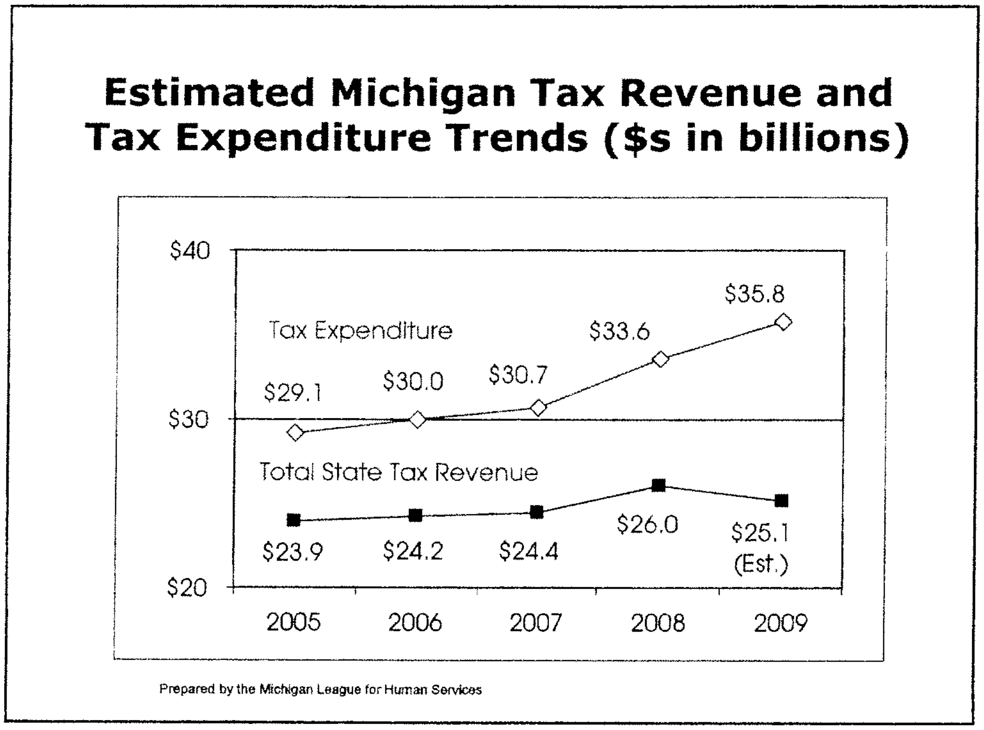
Beer Tax: Held Harmless for Forty Years

- Has not been changed since 1966
- Michigan ranks 28th nationally
- 4 cent per can increase would generate approximately $100 million annually

Estate Taxes: Michigan Stands to Gain Revenue

- 22 states levy an estate or inheritance tax
- 14 states have "decoupled" from federal estate tax
- Michigan could collect $250 million a year by taxing estates


Estimated Michigan Tax Revenue and Tax Expenditure Trends ($s in billions)
$40
$30
$20
Tax Expenditure
$29.1
$30.0
$30.7
$33.6
$35.8
Total State Tax Revenue
$23.9
$24.2
$24.4
$26.0
$25.1 (Est.)
2005
2006
2007
2008
2009
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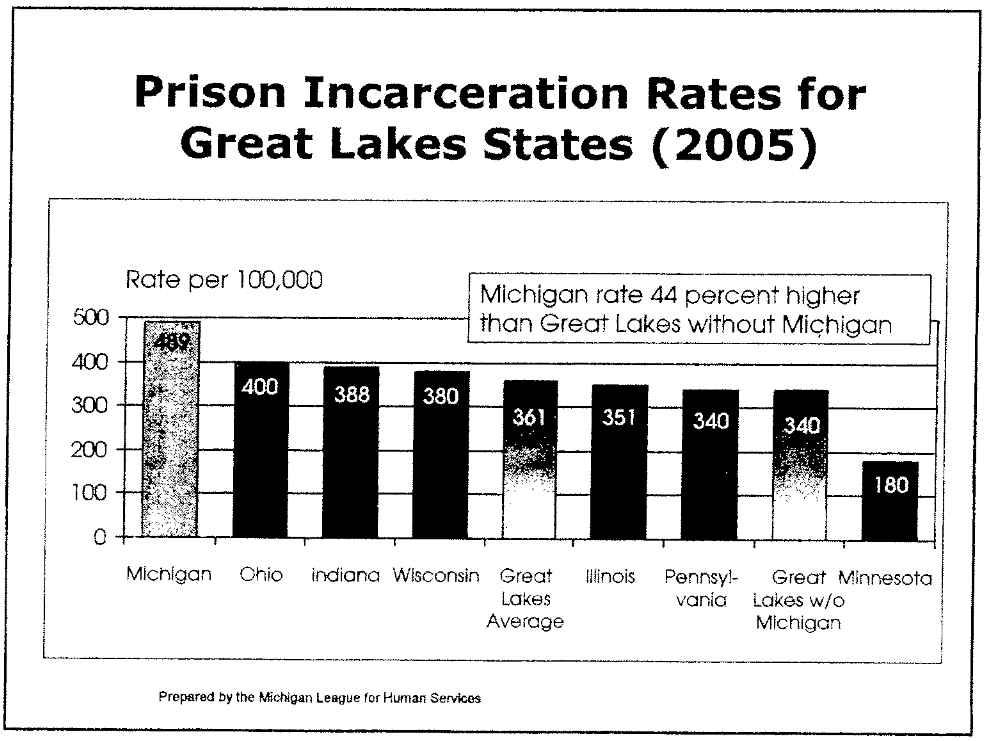
Prison Incarceration Rates for Great Lakes States (2005)
Rate per 100,000
Michigan rate 44 percent higher than Great Lakes without Michigan
500
400
300
200
100
0
489
400
388
380
361
351
340
340
180
Michigan
Ohio
Indiana
Wisconsin
Great Lakes Average
Illinois
Pennsylvania
Great Lakes w/o Michigan
Minnesota
Prepared by the Michigan League for Human Services

Better Options for Addressing the Structural Deficit

- 6 percent Sales Tax on Services - $1.65 billion
- Graduated Income Tax - $600 million
- Reduce Senior Tax Preference - $200 million
- Increase Beer Tax - $100 million
- Decouple from Federal Estate Tax - $250 million
- Tax Expenditure Repeal - $400 million
- Reduce Prison Spending - $300 million

MLHS

Michigan League for Human Services

The Michigan League for Human Services is a state-level policy organization focused on the needs of Michigan's low-income families and individuals. The League's activities include research, analysis, public education and advocacy. The League was founded in 1912 and is a private, nonprofit charitable organization.

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Michigan's Deficit:

- Current year deficit of $1.7 billion addressed with stimulus dollars and $300 million in cuts
- Projected to be $2.4 billion in FY2010
- Projected to be $2 billion in FY2011

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The Budget Deficit: It's Not Just the Economy

There are two kinds of deficits, structural and cyclical. Michigan has both:

1. A cyclical deficit is one that is driven by the economy and business cycle, and goes away in good economic times.
2. A structural deficit exists regardless of the economy—during good times and bad times. It occurs because the state's revenue structure does not bring in enough money to fund services and programs. Because it is structural in nature, it can only be solved by structural changes.

The size of Michigan's deficit

- Fiscal year 2009 marks the ninth consecutive year that state revenues have not been adequate to fund state services and programs.
- The current year's deficit is being addressed with $1.4 billion in federal stimulus dollars and over $300 million in cuts.
- Projections indicate the state faces an estimated shortfall of nearly $2.4 billion for fiscal year 2010, with about $2.1 billion in stimulus dollars available to offset some of that shortfall.
- *Michigan is likely facing a deficit of about $1.8 billion in fiscal year* 2011, after using the remaining $200 million in stimulus dollars.
- Since the first decline in revenues in fiscal year 2001, Michigan has experienced cumulative deficits well in excess of $10 billion, has exhausted over $6 billion in fiscal reserves and has instituted over $4 billion in spending cuts.

The response so far

Over the years, in response to the ongoing structural deficit, the Michigan Legislature cut the budget, raised the income tax temporarily and used other one-time measures. None of these are an acceptable long-term solution. Spending cuts to public safety, health care, human services and education are being felt all across the state. Not only do spending cuts cripple services, but they are also bad for the economy, as they often lead to a further loss of jobs. Given the size of the current deficit and the implications, it is virtually impossible to address the deficit solely through cuts.

While the temporary income tax increase is helping to generate additional revenues for the state; it is only temporary and is declining as large numbers of workers lose jobs. The rate will begin to decline starting in October 2011 and will return to 3.9 percent on October 1, 2015. This will result in a further reduction of state revenues.

Since 2001, Michigan has undertaken a combination of one-time measures, spending reductions and modest revenue enhancements to balance each year's budget. These have not addressed the structural deficit, which is a serious and growing problem. It is time for state policymakers to look at revenue options that will provide long-term solutions.

Better options for addressing the structural deficit

- Extend the 6 percent sales tax to a limited number of services. (Excludes medical, nonprofit and business-to-business services together valued at over $9 billion.)

  Projected Revenue: $1.65 billion

- Institute a graduated income tax. One scenario would reduce the tax burden of more than 90 percent of Michigan filers with a tax liability. The resulting revenue could be expected to grow more rapidly than is the case with the existing flat income tax.

  Projected Revenue: $600 million

- Reduce senior tax preferences to a level equal to Kentucky, the second-most generous senior preference state (Michigan is currently No. 1, by over 27 percent).

  Projected Revenue: $200 million

- Increase the beer tax, which was last adjusted (reduced) in 1966, from 2 cents to 6 cents per 12 ounces. (The proposal would restore two-thirds of the erosion in the purchasing power of beer tax revenues since 1966, due to inflation.)

  Projected Revenue: $100 million

- Decouple from the phase-out of the Federal Estate Tax to permit the state to again receive a portion of the taxes paid by Michigan estates.

  Projected Revenue: $250 million

- Repeal a series of tax expenditures that have, in previous legislative sessions, been approved for elimination by one house or the other, or recommended for repeal by the governor.

  Projected Revenue: $400 million

- Reduce the incarceration rate and average cost per prisoner differentials between Michigan and the other Great Lakes states by 50 percent. While not a revenue enhancement, this recommendation would free up resources for use in resolving anticipated shortfalls.

  Spending Reduction: $300 million

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Sales Tax on Services: Modernizing the Revenue Structure

In 2007, spending on services (as opposed to goods) represented nearly 60 percent of personal consumption nationwide, according to the Institute on Taxation and Economic Policy. When Michigan implemented the sales tax in 1933, however, services represented a much smaller share of personal spending. Currently, Michigan taxes only 26 services out of a possible 168. Modernizing Michigan's tax code to tax additional services is one way to address the state's structural budget deficit.

Services currently taxed in Michigan

Compared with other Midwestern states, Michigan taxes relatively few services, the majority of which are utilities. According to the Federation of Tax Administrators, Illinois taxes 17 services, slightly fewer than Michigan's 26, while Iowa taxes 94.

	Number of Services Taxed
Illinois	17
Indiana	24
Michigan	**26**
Minnesota	66
Ohio	68
Wisconsin	76
Iowa	94

Source: Federation of Tax Administrators, 2007

Michigan's current fiscal situation

Michigan's current fiscal year deficit of approximately $1.7 billion is being addressed with $1.4 billion in federal stimulus dollars and $300 million in Executive Order cuts. For fiscal year 2010, recent forecasts indicate that Michigan is facing a deficit of nearly $2.4 billion, of which approximately $2.1 billion could be offset with federal stimulus funding. In fiscal year 2011, the Michigan League for Human Services projects that the state faces a shortfall of approximately $2 billion, of which only a fraction could be covered by federal stimulus funding.

Taxing services as a tool for revenue growth

In recent decades there has been a significant shift away from the consumption of taxable goods to the consumption of un-taxed services. This shift is having a particularly adverse impact on the School Aid Fund, which has been heavily reliant on sales tax revenues since the passage of Proposal A in 1994.

As households spend less on tangible goods and more on services, expanding the number of taxable services would help mitigate the resulting loss of revenues and provide the basis for future growth. And because Michigan currently taxes so few services, less than 20 percent of those identified in an analysis by the Federation of Tax Administrators, this tax code modernization alternative has great potential for stabilizing and ultimately expanding the revenue available to support Michigan's public schools and other critical public services.

The Michigan Department of Treasury estimates that taxing all services transactions in Michigan's economy at the current sales tax rate of 6 percent would yield over $10 billion annually. If all business-to-business, nonprofit and medical services transactions were excluded from taxation, the potential annual yield of a sales tax on services would be approximately $1.65 billion (see the list below), roughly equivalent to the structural deficit anticipated in FY2011 and out-years.

What could be taxed?

Previous attempts to expand the sales tax to services have failed, due in part to the unevenness of services being taxed, such as taxing skiing services but excluding boat marinas and golf fees. Additionally, businesses would have been expected to pay taxes on services they engage in with other businesses, such as office administration services. These transactions, known as business-to-business sales, have been avoided by most states, as have taxes on health care services and nonprofits. The following list, compiled by the Michigan Department of Treasury, excludes those categories.

Services	**FY 2010 estimates ($s in millions)**
Cable/Satellite TV	$48.6
Entertainment admissions	$95.1
Amusement and recreation (skiing, golfing, bowling, fitness centers)	$98.4
Dry cleaning	$31.5
Landscaping	$62.6
Vended food	$29.5
Personal care services	$89.9
Other personal care services	$104.3
Child care	$44.0
Ground transportation	$22.7
Real estate services	$112.7
Personal share of professional services (including investment advice, legal, accounting, and insurance services)	$240.9
Waste collection (including government contracted)	$45.2
Service contracts	$28.8
Construction (excludes government and business to bussiness)	$299.0
Death care services	$20.4
Repair and maintenance	$220.6
Other services (security, towing, residence care, storage)	$53.9
Total	**$1,648.1**

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Income Tax: It's Time for the Flat Tax to Go

For many years, Michigan has attempted to balance the state budget with one-time fixes, and budget cuts that:

- *limit public safety, road repairs and other vital services; and*
- *fail to fix the structural deficit problem Michigan has faced for many years.*

One piece of a potential solution to this long-standing problem is changing Michigan's income tax from a flat tax to a graduated income tax.

Michigan's current income tax structure

Currently, Michigan taxes all personal income at a flat 4.35 percent. This rate will decline by 0.1 percent starting on October 1, 2011 and each October 1 for five years. By October 1, 2015, the income tax rate will be 3.9 percent. Due to Michigan's flat income tax, the state has not been capturing the growth in income that has been occurring among the state's higher-income taxpayers.

What is a graduated income tax?

In a graduated income tax structure, such as the federal income tax, those with higher levels of personal income are in a higher tax bracket and are taxed at a higher rate and those with lower incomes pay a lower rate. Under such a tax structure, taxpayers in similar economic circumstances pay similar amounts of income tax. One example of a graduated income tax structure:

Tax Bracket	Taxable Income: Single	Taxable Income: Married, Filing Jointly
3.9%	$0-$20,000	$0-$40,000
4.35%	$20,001-$60,000	$40,001-$120,000
6.9%	$60,001 and above	$120,001 and above

The fairness of a graduated income tax versus a flat tax

While everyone pays the same percentage of their income under Michigan's flat tax, that percentage represents a greater share of disposable income for low- to middle-income individuals and families and, therefore, results in a higher tax burden. For example:

- a married couple, filing jointly in Michigan with an income of $40,000 pays a flat income tax of 4.35 percent, or $2,175 a year;
- a married couple filing jointly in Michigan with an income of $1,000,000 also pays 4.35 percent of their income in taxes as well, or $43,500.

The percentage of income taxes paid by the second couple represents a much smaller share of their disposable income. In addition, the top bracket at 6.9 percent would put Michigan in about the middle of states with a graduated income tax:

- below California and Vermont at 10.3 percent and 9.5 percent respectively;
- above Arizona and Mississippi at 4.54 percent and 5 percent.

A graduated income tax and revenue enhancement

Under a graduated income tax system, revenue growth would occur at a higher rate as income growth has been concentrated among groups earning higher incomes, thus creating a more stable and adequate source of revenue for the state to provide necessary services to its residents.

The graduated income tax example used on the previous page would yield an additional $600 million in revenue, and more in the future in response to income growth.

Previous attempts to implement a graduated income tax

To move to a graduated income tax in Michigan, a majority of voters must vote to amend the state Constitution, as it currently prohibits a graduated income tax system. The question has been put to voters on multiple occasions (1968, 1972 and 1976) and has failed.

Recent polling suggests that public attitudes about a graduated income tax could be changing:

- A poll taken in May 2009 found that 60 percent of Michigan voters surveyed now favor a graduated income tax to replace the state's flat tax, while 33 percent are opposed. The poll was conducted by EPIC-MRA of Lansing;
- A Detroit News/WXYZ poll conducted in June, 2007 by EPIC-MRA found that 57 percent of those polled favored a graduated income tax;
- A Detroit Free Press/Channel 4 poll conducted in July and August 2007 by Iowa-based Selser & Co. found that 53 percent favored a graduated structure;
- Michigan State University's 2008 State of the State Survey also confirmed public support for a graduated income tax, with 57.2 percent of those polled in favor.

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Senior Tax Preferences: Can Michigan Afford Such Generosity?

What is a Senior Tax Preference?

Individuals 65 years of age and older are eligible to receive tax exemptions and credits, which vary by state. These exemptions and credits are mainly applied to Social Security income, pension income, and property taxes.

Senior Poverty—Then and Now

Senior tax preferences originated at a time when many seniors were living below the poverty level. Today, age does not have as strong a correlation with poverty as in previous years:

- **1970**—25 percent of individuals 65 years of age and older had income below poverty level.
- **2006**—Only 10 percent of individuals 65 years of age and older had income below poverty level.

Even so, all Michigan seniors, regardless of income, are eligible to receive various state tax exemptions and credits, not available to those under 65.

Michigan's Senior Tax Preferences

Michigan	Exemption	Credit
Social Security Income	Fully exempt from income tax	
Public Pension Income	Fully exempt from income tax	
Private Pension Income	Partially exempt from income tax Cap: $33,550/single—$77,100/joint	
Additional Personal Exemption	$2,000/single—$4,000/joint	
Homestead Property Tax		Up to $1,200
Renters' Tax		Up to $1,200
Other	Exemption of $8,595/single $17,190/joint in interest, dividends, capital gains, federal elderly tax credit deduction	

Senior Tax Preferences:

- Michigan tax breaks for seniors are highest in the country
- Tax breaks are three times the national average
- Michigan could free up $200 million a year and still offer generous breaks

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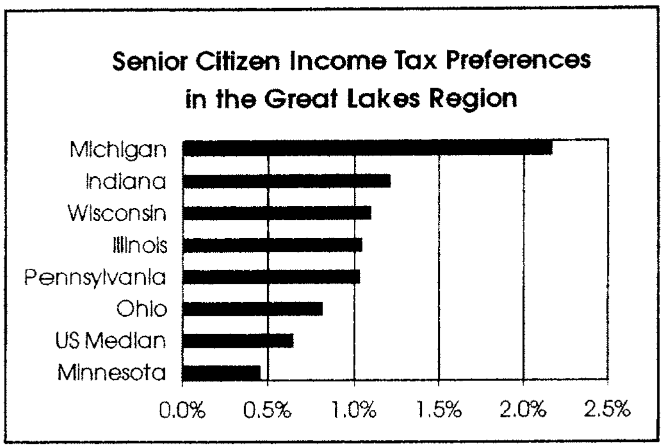
How Does Michigan Compare to Other States?

- Michigan leads all other states with the most-generous senior income tax preferences.
- Michigan's senior tax preference is about double the average of the other Great Lakes states.
- Michigan is much more generous than Kentucky, the second leading state in senior preferences.
- As of 2006, Michigan was one of 28 states that fully exempted Social Security income from taxation.



How Does Michigan Compare to the Federal Government?

Michigan's senior tax preference is over three times the national average. In the mid-1980s, the federal government began to tax a portion of Social Security income in order to restore the finances of the Social Security system. Today, 14 states are following the federal government's senior taxing guidelines, but Michigan is not one of them.

Why Should This Be Addressed?

Michigan's senior population is expected to grow considerably over the next 20 years. In turn, Michigan's revenues will be increasingly drained as a result of generous senior exemptions and credits. This strain on state revenues will come at a time when spending on senior needs and services will be increasing.

- In 2005, 12 percent of Michigan's population was 65 and older. By the year 2030, Michigan's senior population will rise to almost 20 percent of the total state population.
- The Center on Budget and Policy Priorities estimates that over $688 million is annually forgone as a result of Michigan's generous senior tax exemptions and credits, mostly from pension and retirement income tax exemptions.
- Based on the growth of the senior population, Michigan will forgo an estimated $1.15 billion a year by 2030. This would represent 6.2 percent of general fund revenues for the state.

Alternatives for Senior Tax Preferences

Michigan must recognize the difference between effective tax relief for seniors and "poorly targeted tax giveaways." It is estimated by the Michigan League for Human Services that effectively targeted senior tax preferences, similar to those implemented in Kentucky, could return $200 million in much needed revenues to the state. There are also a number of other ways to do this that do not involve the elimination of exemptions and credits altogether:

Social Security taxation options:

- Follow the federal standards for Social Security tax exemptions.
- Set Michigan's specified limit to Social Security tax exemptions.

Pension limits and caps options:

- Freeze the exemption at the current level.
- Phase out pension exemptions at a certain income level.
- Only offer pension exemptions to taxpayers with income below a specified level.
- Lower the cap on the amount of private pension that can be exempted.
- Grant pension exemptions only to individuals above a certain age level.
- Eliminate the exemption altogether and grandfather in the seniors who currently benefit.

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Beer Tax:
Held Harmless for Forty Years

Michigan has taxed beer since 1933 and currently imposes a tax of $6.30 per barrel (2 cents a can). The rate has not been changed since 1966, when it was actually reduced from $6.61 per barrel. Michigan's $.20 per gallon tax is below the national average of $.28 per gallon and ranks Michigan 28th out of 50 states in its beer tax rate.

Since 1966, inflation has reduced the purchasing power of beer tax revenue by approximately 84 percent. A 4 cent increase in the beer tax, bringing the tax to 6 cents a can, would generate approximately $100 million in additional revenue, which could be used to help fund state services.

Inflation Adjusted Cost and Tax Per 12 Ounce Serving of Beer (1966 vs. 2009)

	1966	2009
Cost per 12 ounces	$0.20	$0.14
Tax per 12 ounces	$0.02	$0.003
Tax as a percent of cost	10%	2%
Loss of tax revenue purchasing power from 1966 to 2009		-84%

Notes: 1966 was adopted as the base year for purposes of this analysis because it was the last time Michigan's beer tax was adjusted (reduced) to $6.30/barrel, equivalent to approximately 2 cent per 12 ounces.

The U.S. Consumer Price Index was used to adjust 2009 values for inflation.

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Estate Taxes: Michigan Stands to Gain Revenue

Taxes paid on inherited wealth have been a traditional source of revenue for Michigan and other states.

Michigan and other states used to receive a portion of the federal estate tax called a "pick-up" tax. In 2001, however, Congress approved a phase-out of the federal estate tax by 2010. Between 2001 and 2005, it also phased out the state share, eliminating the pick-up tax completely in 2005.

In fiscal year 2000, Michigan collected $185.5 million in estate taxes. Michigan now collects nothing on the estates of its wealthiest citizens.

Other states have acted

Each state has the option of "decoupling"—divorcing itself—from the federal estate tax and reverting to the federal law as it existed prior to the 2001 changes.

According to the Center on Budget and Policy Priorities, state taxes on inherited wealth are common. In all, 22 states collect estate or inheritance taxes. They are:

- 11 states (Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Oregon, Rhode Island and Vermont) and the District of Columbia that decoupled from the federal estate tax and levied an estate tax similar to the earlier pick-up tax;
- Three states (Connecticut, Kansas and Washington) that replaced their pick-up taxes with estate taxes not tied to the federal tax; and
- Eight states (Indiana, Iowa, Kentucky, Nebraska, Ohio, Oklahoma, Pennsylvania and Tennessee) that have a state inheritance tax that was never connected to the federal pick-up tax.

Of the 22 states, Maryland and New Jersey levy both an estate tax that is similar to the 2001 tax and a separate inheritance tax.

A Michigan inheritance tax adopted in 1899 was eliminated in 1993, so Michigan has neither a separate inheritance tax nor has it acted to decouple to restore the pick-up tax revenue.

Needed revenues

At a time when state revenues are falling dramatically, decoupling from the estate tax would generate revenue that could help protect services to vulnerable citizens, public safety and education.

Gov. Jennifer Granholm supports a state estate tax. She most recently called for decoupling to help balance the fiscal year 2008 budget. The governor called for taxing estates valued at more than $2 million, except for family farms or businesses. The bills were not passed.

The League estimates that Michigan could collect more than $250 million a year by "decoupling" and returning to the 2001 status when estates of $675,000 or more were taxed. If estates were limited to those of $2 million or higher, the revenue generated would be an estimated $160 million a year.

The federal Economic Growth and Tax Relief Reconciliation Act of 2001, which phased out the federal estate tax, is scheduled to sunset in 2011. If it sunsets, it would allow the federal tax code to revert back to provisions in place in 2001 and restore the state pick-up tax, in which case revenue would flow to Michigan. In lieu of the sunset, Congress could repeal the estate tax altogether or create another estate tax.

Other reasons to decouple or pass a state estate tax

- A study by the Brookings Institute found estate taxes give a strong incentive for tax-deductible charitable giving. Without the federal estate tax, it could result in the loss of as much as $10 billion in annual contributions nationwide.
- Bill Gates Sr., the father of Microsoft co-founder Bill Gates, supports restoration of the federal estate tax. He says estate taxes should be viewed as an opportunity cost that allows a contribution from those who have benefited the most from a free and stable society.
- In 2000, the wealthiest 1 percent of families owned more than 40 percent of the nation's private assets, up from about 20 percent in 1976, according to the Census Bureau. The lack of an estate tax makes a state's revenue structure more regressive.
- Most other Great Lakes states—Illinois, Ohio, Indiana and Minnesota—have an estate or inheritance tax.

Calendar Year	Estate Tax Filing Threshold	Highest Estate & Gift Tax Rate	State Credit Percentage
2001 (Base year)	$675,000	60%	100%
2002	$1,000,000	50%	75%
2003	$1,000,000	49%	50%
2004	$1,500,000	48%	25%
2005	$1,500,000	47%	0%
2006	$2,000,000	46%	
2007	$2,000,000	45%	
2008	$2,000,000	45%	
2009	$3,500,000	45%	
2010	Tax repealed	35% (Gift Tax only)	

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Tax Expenditures: Silently Draining the State Budget

At a time when state and local revenues are plummeting and the state faces a serious structural budget deficit, the Michigan Legislature continues to pass tax expenditures that would further erode state and local revenues. Over a billion dollars of tax expenditures have already been passed out of legislative committees during this legislative session. This briefing examines tax expenditures and provides recommendations on how to improve the tax expenditure process.

What are tax expenditures?

Simply put, tax expenditures reduce or eliminate taxes that would have been otherwise paid by individuals and entities, thereby reducing tax revenues. Tax expenditures can be defined broadly as the tax revenue forgone as a result of preferential provisions such as credits, deductions, exemptions, deferrals, exclusions on lower tax rates, according to the Michigan Department of Treasury. These provisions are tax expenditures because, like appropriations, they allocate resources for specific public purposes, but do so through the tax system rather than the expenditure system.[1]

How much does Michigan "spend" on tax expenditures?

Tax expenditures are projected to increase 6.7 percent between fiscal year 2008 and fiscal year 2009—from \$33.6 billion to \$35.8 billion, according to the Michigan Department of Treasury.[2] To put that in perspective, Michigan's total state tax revenue for fiscal year 2009 is estimated to be \$24.2 billion. Tax expenditures—the revenue Michigan forgoes—are growing at a faster rate than state tax revenue. Between 2005 and 2008, tax expenditures grew by about 15 percent compared with an 8.8 percent growth in total state tax revenue.[3]

Tax Expenditures:

- Total over \$35 billion
- Will increase by an estimated 7 percent between 2008 and 2009
- Grow faster than state revenue

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[1] Executive Budget Appendix on Tax Credits, Deductions, and Exemptions, Fiscal Year 2009.
[2] Ibid.
[3] Michigan League for Human Services, May 2008.

Why should we be concerned about tax expenditures?

Tax expenditures:

- reduce revenues available to the state for spending;
- can grow in cost;
- are not regularly reviewed by the Legislature; and
- do not have to go through the appropriations process.

Like spending on specific programs, tax expenditures directly impact the state budget, but they do so in a more silent way. Some have even referred to tax expenditures as "silent spending." Particularly during difficult budget times, state spending is closely scrutinized by the governor and the Legislature. In order for any spending to occur, it must first be authorized by the Legislature and the Governor. There is no continuation funding for state programs. Tax expenditures, on the other hand, continue on without authorization, unless they are eliminated.

Over the last several years, more than $4 billion has been cut from the state budget, but few if any tax expenditures have been eliminated. When the governor and Legislature look at revenues available and line items in the budget, tax expenditures are not a part of that discussion. Essential services are being cut and eliminated while tax expenditures continue without evaluation. A list of tax expenditures is included in the governor's budget, but unlike budget bills, the list is not debated by the Appropriations Committees.

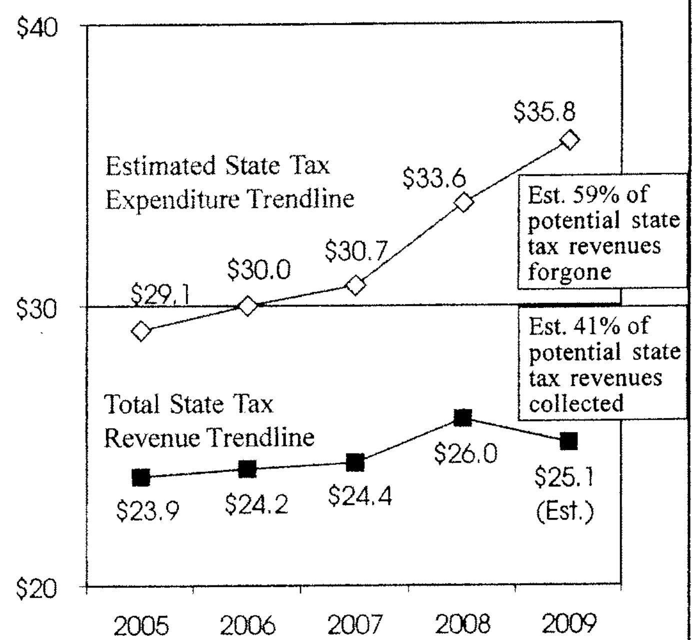
Do tax expenditures stimulate economic development?

Defenders of tax expenditures often use the argument that such expenditures are needed in order to stimulate economic development and to create jobs. The evidence, however, suggests otherwise. According to a 2003 report for the Louisiana Department of Economic Development, tax incentives "often have no measurable impact on growth, and even when they do, it is likely that they are not cost-effective...most economists in the field would recommend economic development policy based on sufficient and appropriate infrastructure investments and service provision, and a balanced, predictable and fair tax system."[4]

How could the tax expenditure process be improved?

The Legislature should take action to require that every tax expenditure be reviewed by the appropriate appropriations committee as part of the budget process. Rather than just allowing tax expenditures to continue without review, a decision should be required as to whether a tax expenditure continues or ends. Tax expenditures should be evaluated to determine whether they are still necessary, are meeting their goals, are cost-effective, are benefiting the public at large and are worth their cost to the state budget. Some tax expenditures are worthwhile and a good use of state money, others are not. A review system is needed to determine which is which.

Estimated Michigan Tax Revenue and Tax Expenditure Trends
($s in Billions)



Data Sources: Michigan Department of Treasury Executive Budget Appendix on Tax Credits, Deductions and Exemptions FY2005 - FY2009 and Department of Management and Budget Comprehensive Annual Financial Reports

[4] Dave N. Norris and Elizabeth Mansager Higgins, The Impact of Economic Development Incentive Programs: A Review of the Literature, Louisiana Tech University, 2003.

Michigan League FOR Human Services

Facts Matter

Facts Matter is a series of briefs highlighting Michigan's budget and tax system

Corrections:

- Michigan is one of only four states that spends more on prisons than higher education
- Corrections workers now number nearly one in every three state employees
- Michigan has the highest incarceration rate among the Great Lakes states

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Prison Spending: Corrections Takes Big Bite of Budget

When it comes to the state budget, there is a trio of big-ticket items that drive spending: Medicaid, corrections and higher education.

State Medicaid spending has grown, driven by need and the matching dollars offered by the federal government. Corrections, too, has grown, driven by demand for prison space. As a result, higher education has been squeezed. Michigan is one of just four states that spends more on prisons than higher education, according to a 2008 study by the Pew Center on the States.

How did prisons grow beyond higher education?

In the 1980s, beginning in the administration of Gov. Jim Blanchard and continuing through Gov. John Engler's years, there was a massive expansion of the state prison system. Over the past 25 years, the prison population has exploded from 15,000 inmates to more than 47,000 today.

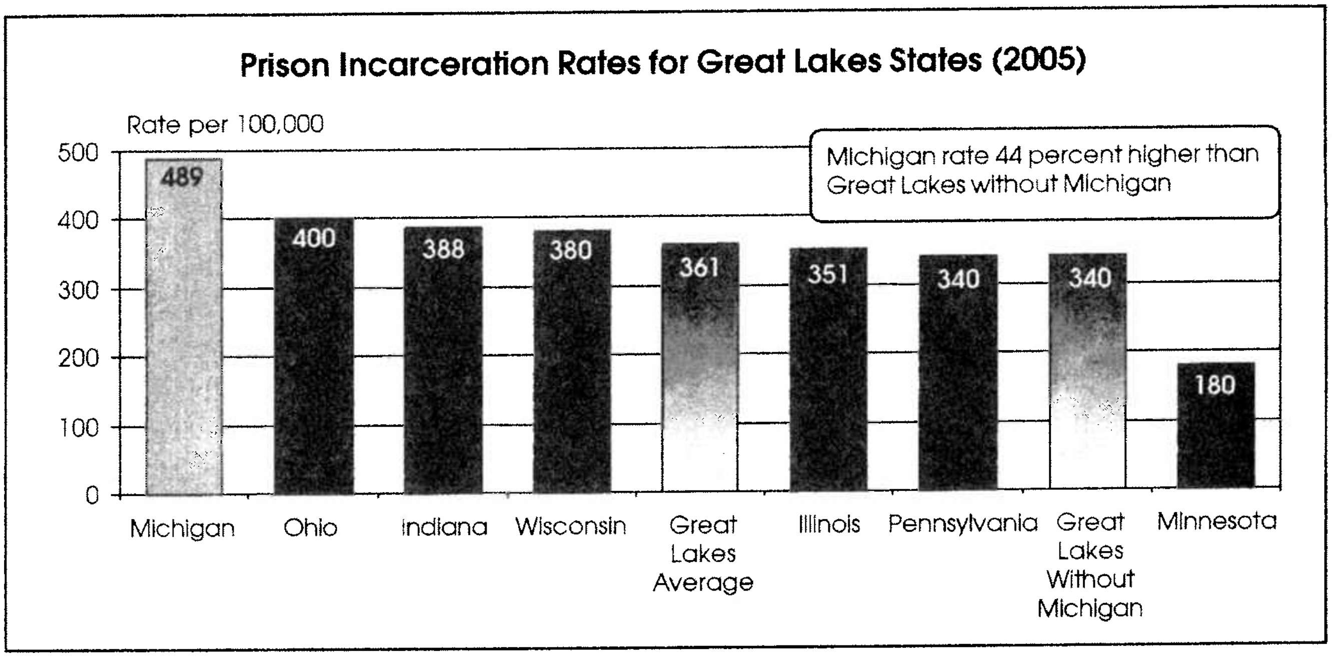
The state workforce has shifted, too. In 1973, one in every 20 state workers was a corrections employee. As of March 2009, corrections workers made up 30 percent of the state workforce—nearly one in every three.

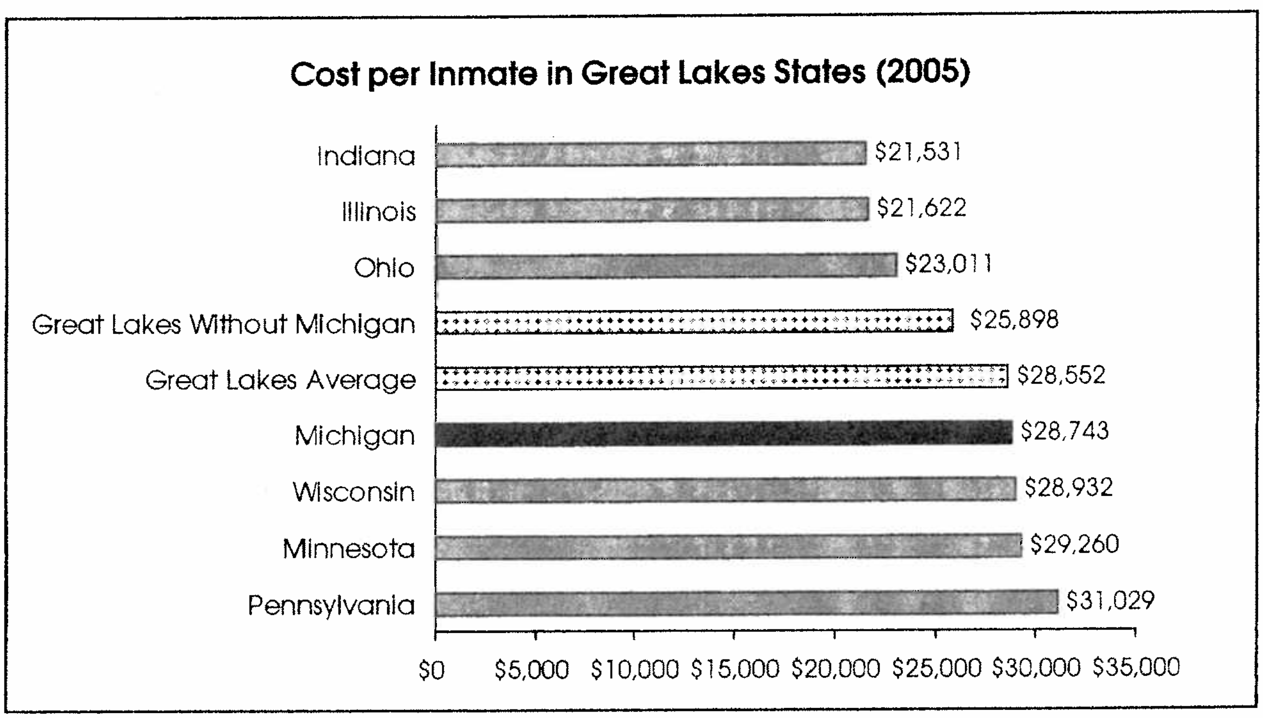
Driving these trends was a tough-on-crime political era and a system of parole that has resulted in longer average prison sentences. The administration of Gov. Jennifer Granholm has embarked on a project to reduce recidivism by providing more services to parolees. In addition, parole rates are up, and the prison population dropped from a peak of 51,500 in 2006 to 47,552, as of June 1, 2009. Nonetheless, while corrections pending has slowed, it still consumes a quarter of the state's General Fund.

Michigan is out of step with spending in other Great Lakes states

Among its neighbors, Michigan has the highest incarceration rate and above-average per-prisoner cost.

The Michigan League for Human Services estimates that closing the gap by 50 percent between the average of the other Great Lakes states and Michigan in these two areas, would free up $300 million a year for spending on other services.





Prepared by Michigan League for Human Services